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SUBJECT: IMF NEGATIVE ON UKRAINE BUDGET BOMB

REF: KYIV 2434

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¶1. (SBU) Summary. The local IMF office has unofficially told us that the 2009 budget is "quite negative" and likened the budget's failure to reign in pension outlays to an "exploding bomb." According to the IMF, the 2009 budget is based on unrealistic macroeconomic projections and a 2.97 percent deficit that is far higher than allowed under the IMF's Stand-By Arrangement (SBA).

¶2. (SBU) After four attempts by Ukraine's parliament, the Verkhovna Rada passed a 2009 budget bill on the narrowest of margins on December 26. President Viktor Yushchenko signed the budget into law on December 29, but only after extracting a promise from PM Yulia Tymoshenko that the budget would be amended when the Rada returns from its holiday recess. Critics appeared from all corners; some ministries condemned the allocations as spendthrift or misdirected, while the President's office called the GOU's revenue indicators "virtual rather than realistic." End summary.

#### IMF on the Foreseen Deficit -----

¶3. (SBU) The IMF's local budget expert Igor Shpak told us on December 30 that the IMF has yet to voice an official view of the 2009 budget. Unofficially, however, the IMF had a "quite negative" assessment of the budget, he said. (Note: The IMF recently pulled its residential representative from Kyiv - see reftel. Shpak is one of several local employees in the leaderless office and an expert on macroeconomic and budget issues. End note) The budget's UAH 31.105 billion (roughly \$4.15 billion) deficit, projected at 2.97 percent of GDP, is far higher than is allowed under the IMF's \$16.4 billion SBA, even after acceptable adjustments are made for bank recapitalizations and project finance. Shpak said that the maintenance of a balanced budget conditionality would be a "key subject" for the IMF review team, slated to appraise Ukraine's SBA implementation in late January.

¶4. (SBU) Even if the balanced budget conditionality were modified to account for a worse economic situation since the SBA was approved in October, said Shpak, the GOU would "still have a bad budget," since it is based on unrealistic macroeconomic projections that underpin the GOU's GDP and revenue forecasts. The government's estimation that 2009 GDP growth will be 0.4 percent was unrealistic, he said. (Note: Leading think tanks such as Kyiv-based ICPS have published baseline growth predictions at or below -5.5 percent. End note) Furthermore, said Shpak, the budget relies on an unsustainable amount of domestic borrowing, targeted at UAH 70 billion after the GOU only raised UAH 10 billion in 2008 domestically. Heavy public borrowing, even at far lower levels than those foreseen in the 2009 budget, would seriously crowd out private sector borrowing and contribute to the economic downturn, he said.

The biggest drag on the budget is the "exploding bomb" of an unreformed pension system. Since the Rada voted down legislative measures that would have capped increases for the most privileged pension recipients, the GOU will now be forced to increase revenues.

Rada Speaker Volodymyr Lytvyn told the IMF, according to Shpak, that MPs are prepared to take measures to increase revenues when they return from their holiday recess in mid-January.

#### Absentee Support

15. (U) It took the Rada four attempts to pass the 2009 bill with 226 out of 450 votes - the required minimum. All members of the BYuT and Lytvyn factions supported the budget, as did 46 OU/PSD MPs. The Communist faction did not vote, neither did United Center or For Ukraine MPs.

16. (SBU) The murkiest story coming out of the Rada's deliberations was the absentia support of three MPs - two from Party of Regions, Volodymyr Hureyev and Petro Korzh, who defied their faction's leadership in favor of the bill. After the vote, deputy Regions head Oleksandr Yefremov claimed that Hureyev and Korzh's voting cards had been illegally tampered with in their absence. BYuT MP Ihor Rybakov likewise issued a statement that he had been physically absent from the session hall during the vote, that his voting card was with him in his absence, and that the vote marked under his name had been falsified.

#### Critics from All Corners

17. (SBU) After declaring that "a bad budget is better than no

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budget," President Yushchenko signed the bill into law on December 29. Yushchenko and Tymoshenko arranged that the Rada would take up possible budget amendments in January, when new economic growth and revenue figures are released.

18. (SBU) Through Presidential Secretariat deputy Oleksandr Shlapak, the Yushchenko camp declared the GOU's revenue estimates to be "virtual rather than realistic," pointing to overrated macroeconomic indicators that hide an additional revenue shortfall of UAH 20 billion (roughly \$2.67 billion) beyond the budget's current projections. Shlapak criticized the projected growth in state debt of UAH 103 billion (roughly \$13.7 billion) which, as foreseen by the budget, would be financed by domestic borrowing of UAH 70 billion (\$9 billion). Such figures would "more than double" state debt and increase borrowing seven-fold, money that banks cannot supply, according to the President's aide. In addition to current outlays for wages and social programs, an additional UAH 6 billion (\$780 million) must still be budgeted for the "imbalanced" Pension Fund, said Shlapak.

19. (SBU) Ukrainian Defense Minister Yuriy Yekhanurov lashed out at Rada members who put social programs and subsidies ahead of servicemen and other budget sector workers. To pay for pensions, said Yekhanurov, other budget items, including Defense Ministry programs, have been tapped. The Ukrainian armed forces are due to receive UAH 7.4 billion (roughly \$1 billion) in 2009, against UAH 9 billion in 2008.

110. (SBU) Ukrainian Emergencies Minister Volodymyr Shandra likewise expressed frustration with the amount of funds allocated to his Ministry. "I think nobody is satisfied with that budget -- the state is obliged to ensure social standards, territorial integrity, and protection from crime for its citizens."

111. (SBU) Comment. Since it was released publicly on December 29, the biggest question in Kyiv among GOU fiscal policy watchers has been whether the 2009 budget meets IMF standards. Clearly, according to the IMF's own expert, the budget fails on this and other accounts. It's possible that the upcoming program review, slated for the second half of January, will lead to a modification of the balanced-budget requirement because the economic situation has deteriorated far faster than anyone, including the IMF, could

have foreseen in October, when the SBA was approved. However, the IMF will continue to insist on budget discipline, even if it allows a modest deficit. Looking forward, we expect the GOU to seriously test the IMF's willingness to adhere to whatever budget conditionalities it imposes on Ukraine. The fractured political landscape will continue to make it difficult for the GOU to take the painful measures necessary to establish true budget discipline, and various ministers' outcries over the cuts in their respective budgets this week indicate that the Rada will face pressures to increase allocations to key ministries with political clout. Whether the IMF rolls over on its balanced budget conditionality will be an early key indicator of its SBA's prospects for success. End comment.

TAYLOR